

Resolving Too Big to Fail

Nicola Cetorelli, FRBNY
James Traina, UChicago

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Too Big to Fail and Living Wills

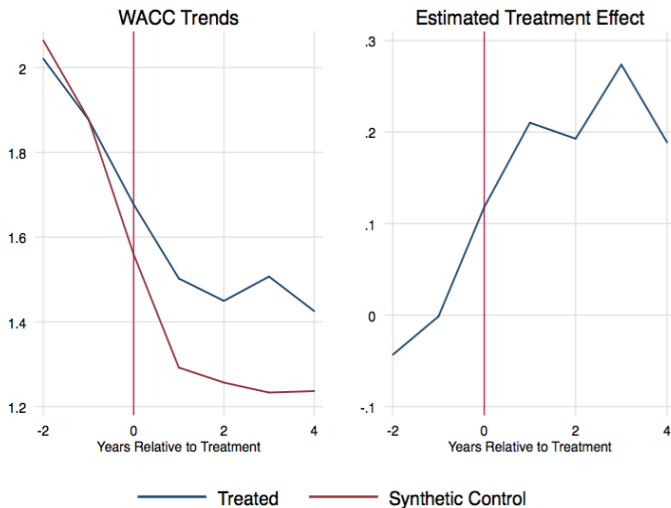
- Large financial institutions enjoy implicit TBTF guarantees
- Subsidizing downside risk causes artificially lower costs of capital
 - Transfer from taxpayers to investors
 - Incentives to take on more risk or grow beyond optimal scale
- Dodd-Frank implemented living wills as a policy solution
 - Large and complex financial institutions detail how they could unwind positions when distressed without systemic impact
- Effective living wills create conditions for orderly liquidation
 - Should lead to lower subsidies, and therefore higher costs of capital

- Test whether living will regulations increase financing costs
 - May also decrease systematic risk by changing bank behavior, decreasing financing costs, so estimates are a lower bound
- Measure cost of capital using filings and analyst forecasts

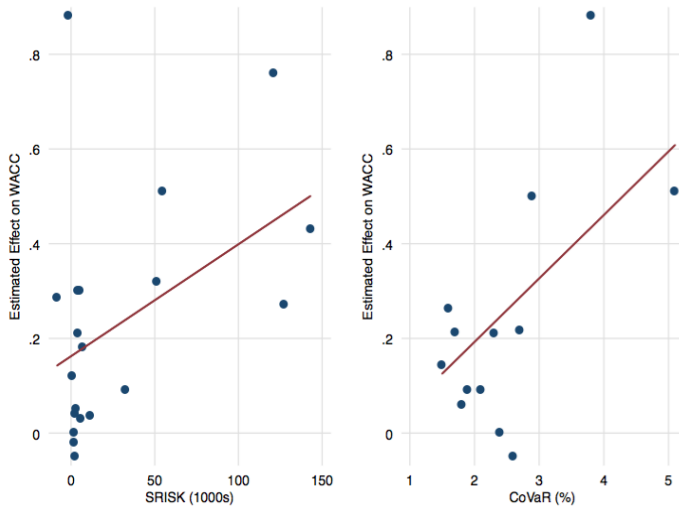
$$P = \sum_{t=1}^{\infty} \frac{E[CF_t]}{(1 + CEC)^t}$$

- Treated banks are larger and more complex than untreated banks
 - ... so we use a synthetic control approach to balance our comparison
- Also allows us to estimate a separate treatment effect for each bank!

Increases in the Cost of Capital



Stronger Effects in Systemically Important Banks



Perspective on Economic Significance

- 22 bps cost increase is in the ball park of a TBTF subsidy
 - Typical estimates range from 20 bps to 100 bps
- \$42B implied subsidy is in the ball park of the Paulson plan transfer
 - Veronesi and Zingales (2010) estimate “...a massive transfer of resources from the taxpayers to the banking sector”
 - Benefits to bank investors of \$107B, costs to taxpayers about \$36B
 - Driven by a decrease in the perceived risk of bankruptcy
 - This bailout was a unitary event, our implied subsidy is annual